

**Office of Chief Counsel  
Internal Revenue Service  
memorandum**

CC:PA:03:KLBrau  
LEG-142031-08

UILC: 53.00-00

date: February 12, 2009

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(Small Business/Self-Employed)  
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from: Gerald Ryan  
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subject: Application of payments to unpaid liabilities that include portions of regular (non-ISO) tax liabilities and ISO AMT tax liabilities

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This memorandum responds to your inquiry about how to apply payments for tax years in which a taxpayer was liable for taxes due to the application of section 56(b)(3) of the Internal Revenue Code.

This office coordinated with the Office of the Associate Chief Counsel (Income Tax and Accounting) in preparing this advice. This advice may not be used or cited as precedent.

**ISSUE**

For tax years in which a taxpayer is liable for both ISO AMT subject to section 53(f) relief and other taxes (non-ISO AMT), should the Service apply the taxpayer's payments first to the non-ISO AMT liabilities and related interest and penalties (if any)?

**CONCLUSION**

Yes. The Service should exercise its discretion to apply the taxpayer's payments first to the non-ISO AMT liabilities and related interest and penalties (if any).

**PMTA 2009-027**

## DISCUSSION

Section 56(b)(3) subjects the exercise of certain incentive stock options (ISOs) to alternative minimum tax (AMT). For example, if a taxpayer's employer offers the taxpayer the option to buy the employer's stock at \$10 per share and the taxpayer exercises the option when the shares have a fair market value (FMV) of \$50, the taxpayer's "gain" of \$40 is subject to AMT (ISO AMT). Often, taxpayers who do not sell the stock immediately after exercise lack the funds to pay their taxes (both ISO AMT and other tax liability) in the year of exercise.

Congress enacted section 53(f)(1) to relieve taxpayers of ISO AMT liabilities (outstanding as of October 3, 2008) "attributable to the application of section 56(b)(3) for any taxable year ending before January 1, 2008[.]" Section 53(f)(1) abates any unpaid ISO AMT tax liability, including the interest and penalties, and gives taxpayers an AMT credit for any ISO AMT taxes previously paid. Effectively, section 53(f) retroactively forgives the ISO AMT liability. It would be illogical to apply a taxpayer's payments to the ISO AMT liability that Congress sought to forgive. Therefore, the Service should apply all payments in years with both ISO AMT and other (non-ISO AMT) liabilities first to the other tax liabilities, and related penalties and interest (if any). The Service should treat any payments in excess of the non-ISO AMT liability consistently with section 53(f). In our view, offsetting a taxpayer's liabilities in any other manner would be contrary to the intent of Congress in enacting section 53(f).

In addition, Rev. Proc. 2002-26, 2002-1 C.B. 746, states the Service's position regarding how the Service applies payments against assessed tax, penalty, and interest to one or more taxable periods. Section 3.01 of the revenue procedure permits taxpayers to designate how voluntary partial payments are applied to their tax liabilities. If the taxpayers fail to make a designation, section 3.02 provides that the Service will apply the payments in the order of priority that the Service determines will serve its best interest. As a general rule, section 3.02 states that payments will be applied to tax, penalty, and interest, in that order, until the amount is absorbed. However, case law has held that if the taxpayer makes a voluntary payment without directing the application of the fund, the Service may make whatever allocation it chooses. See, e.g. Muntwyler v. U.S., 703 F.2d 1030, 1032 (7<sup>th</sup> Cir. 1983).

Accordingly, the Service has the discretion to not apply the general rule in Rev. Proc. 2002-26 if the Service determines that it is in its best interest to apply payments in a manner that implements the section 53(f) relief intended by Congress. This policy is consistent with Rev. Proc. 2002-26. In this case, it is in the best interest of tax administration to apply the taxpayer's payments first to the non-ISO AMT liabilities and related interest and penalties. This also seems sound given the fact that taxpayers who made little or no payments are receiving more of an ISO AMT abatement than those who made partial payments or chose to exercise other rights available under the Code.

A taxpayer who has entered into an offer in compromise (OIC) with the Service to settle ISO AMT tax liabilities should be treated consistently with the approach outlined above. Again, the Service should apply all payments in years with both ISO AMT and other (non-ISO AMT) liabilities first to the other tax liabilities, and related penalties and interest (if any). The Service should treat any payments in excess of the non-ISO AMT liability consistently with section 53(f).

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call (202) 622-3600 (P&A Branch 3) and/or (202) 622-4920 (ITA) if you have any further questions. For questions regarding an OIC, please call (202) 622-3620 (P&A Branch 5).